



EUROPEAN COMMISSION

HIGH REPRESENTATIVE OF THE
EUROPEAN UNION FOR
FOREIGN AFFAIRS AND
SECURITY POLICY

Brussels, 3.5.2012
JOIN(2012) 11 final

JOINT REPORT TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Hong Kong Special Administrative Region: Annual Report 2011

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INTRODUCTION

Since the handover of Hong Kong to the People's Republic of China almost fifteen years ago, the European Union and its Member States have closely followed political and economic developments in the Hong Kong Special Administrative Region (SAR). In order to fulfil the 1997 commitment to the European Parliament an annual report is issued on developments in Hong Kong. This is the fourteenth such report covering developments in 2011.

During 2011, the principle of 'one country, two systems', enshrined in the Sino-British Declaration and the Basic Law of Hong Kong, continued to work well, as the rights and fundamental freedoms of the people of Hong Kong continue to be respected, the rule of law protected and the market economic system and business environment maintained.

Bilateral relations between the EU and Hong Kong have continued to expand culminating with the visit of the Hong Kong SAR Chief Executive to the EU institutions in September where he met with President Van Rompuy.

The European Union attaches great importance to Hong Kong's stability, economic prosperity and democratic development. The EU continues to strongly support early and substantial progress towards the goal of universal suffrage, in accordance with the Basic Law of the Hong Kong SAR and the wishes of the people of Hong Kong.

POLITICAL DEVELOPMENTS

2011 saw further consolidation of Hong Kong's constitutional development. Subsidiary legislation on the electoral reform package agreed in June 2010 was approved, a robust public debate and extensive media scrutiny took place and political momentum was building up in advance of the district council elections and the constitution of the expanded Election Committee that will choose the next chief executive in March 2012.

On 22 July 2011, the Secretary for Constitutional and Mainland Affairs published a consultation paper on arrangements for filling vacancies in the Legislative Council. By the end of the consultation period on 24 September 2011, the majority of respondents considered that the by-election system should be retained, rejecting the original government proposal that the vacancy would be filled by the next candidate on the list. The adoption process will be completed within the 2011/2012 legislative year.

In his last policy address on 12 Oct 2011 entitled 'From Strength to Strength', the Chief Executive Donald Tsang, shifted focus onto Hong Kong's social challenges. He targeted unaffordable housing, Hong Kong's rapidly ageing population, and the increasing wealth gap and promised to take steps to improve the general quality of life.

District Council elections were held on the 6 November 2011. Voter turnout reached 41.4% with 1.2 million people casting their vote. The Democratic Alliance for the Betterment and Progress of Hong Kong (DAB) and the Federation of Trade Unions won 165 of the 412 seats; the pan-democratic camp won only 47 seats. The district council elections set the scene for a series of elections to be held in 2012 including the next legislative council elections in

September 2012 with five new functional constituency seats drawn from these elected district councils. Allegations of irregular voter registration were subject to investigations.

On 10 December 2011, the newly expanded Election Committee, comprising 1,200 seats that will elect the next chief executive in March 2012, was constituted with appointments from business, the professional sectors, civil society and politicians at district and Legislative Council level. In late 2011, two candidates declared their intention to run for the next Chief Executive post: Henry Tang, former Chief Secretary declaring on 26 November and Chun-Ying Leung, former Executive Council Convener on 27 November.

Hong Kong-Taiwan relations took an important step forward this year with the formalisation of their relations and presence of official offices in Taipei and in Hong Kong. In July 2011, Taiwan opened an official representative office in Hong Kong, the Taipei Economic and Cultural Office. Hong Kong's office in Taipei is called Hong Kong Economic, Trade and Cultural Office. Hong Kong and Taiwan also embarked on an increasingly substantive bilateral agenda including trade and investment, aviation, custom and cultural cooperation.

The maintenance of the rule of law and the independence of the judiciary continued to play a key role in securing Hong Kong's long term prosperity. In his first opening of the Legal Year, on 10 January 2011, Chief Justice of the Court of Final Appeal Geoffrey Ma Tao-li underlined three fundamental features of the rule of law in Hong Kong, namely the existence of laws that respect the rights and the dignity of persons; an independent judiciary which protects these laws and a proper administration of justice. The Hong Kong's judicial arm continues to protect the rights and liberties that exist in Hong Kong and ensures that everyone is treated equally and in accordance with the law.

A number of important judgements were delivered this year. On 8 September 2011, the Court of Final Appeal, in line with the interpretation made by the Standing Committee of the National People's Congress pursuant to article 158 of the Basic Law, judged that the "one country, two systems" principle did not extend to the doctrine of state immunity in the FG Hemisphere/Congo case, and confirmed that a foreign state's commercial activities are immune from litigation in Hong Kong. The Hong Kong Bar Association said there was no question of the judicial autonomy of the courts being compromised by the decision. The case involved decades-old debt of US\$100 million owed by the Democratic Republic of Congo to FG Hemisphere, a US fund. The Court of First Instance also ruled on 30 September 2011 that a foreign domestic helper should be allowed to apply for permanent residency in the city. The Government appealed against the ruling, with the case sparking widespread debate on equal treatment for foreign maids. The Court of Appeal overturned the ruling of the Court of First Instance on the construction of the Hong Kong-Zhuhai-Macao Bridge giving the green light for the infrastructure project to be built. The Court of First Instance had judged that the Environmental Protection Department failed to conduct an analysis of the projected environmental conditions putting the construction work on hold.

During 2011, Hong Kong residents continued to exercise their rights of freedom of speech and association, culminating in the largest numbers for the annual July 1 march since 2004.

ECONOMIC AND TRADE DEVELOPMENTS

The Hong Kong economy was in good shape in 2011. It expanded at a solid pace in the first half of the year, thanks to robust exports of services and goods as well as strong domestic demand. However, the growth momentum moderated in the second half of 2011 given a weakening of the external environment. GDP growth for 2011 as a whole slowed to 5% in

real terms, following a 7% increase in 2010. The labour market was in a state of full employment, with an annual unemployment rate of 3.4%. Inflation rose markedly to 5.3%¹.

Fighting inflation and containing the property market bubble risk were perceived as the biggest challenges to the Hong Kong economy at the start of 2011. The Hong Kong SAR Government thus introduced a number of measures to counter the impact of inflation and cool down the property market in the 2011-12 fiscal budget. Among them, the Financial Secretary proposed a one-off HK\$6,000 handout to all permanent residents aged 18 and above and withdrew his original proposal to inject the same amount into each of the mandatory provident fund accounts. The direct cash handouts were unprecedented in Hong Kong's fiscal policy history. Hong Kong SAR Government enjoyed a sound fiscal position and significant reserves that reached HK\$595 billion as of end-March 2011, equivalent to 34% of GDP².

Upon entering the second half of 2011, the Euro zone sovereign debt crisis raised concerns in Hong Kong, despite a limited exposure of Hong Kong banks. The property market showed some consolidation given the more cautious sentiments of the market. The stock market underwent a sharp correction with the Hang Seng Index closing the year 20% lower than 2010³. Total equity capital raised at the Hong Kong Stock Exchange also fell sharply in 2011⁴. However, Hong Kong still ranked first in terms of funds raised through IPOs globally for the third consecutive year.

The three main economic legislative proposals introduced in 2010, i.e. the minimum wage law, the competition bill and the law and provisions on the exchange of tax information, progressed at different paces in 2011. The Minimum Wage Law, which sets out a minimum wage level of HK\$28 per hour, took effect from 1 May 2011. Over the last year, the labour market remained in good condition and reached full employment. The long-awaited Competition Bill continued to be debated in the Legislative Council with strong opposition from business sectors. In October 2011 the government introduced amendments to the original proposal seeking to address some of the business community concerns. Since adopting legislation on aligning exchange of tax information arrangements with international standards in March 2010, Hong Kong has signed 17 new tax agreements with third countries in less than two years (including 11 with EU Member States).

For the first time, the role of the Hong Kong SAR was the subject of a dedicated chapter of China's 12th Five-Year Plan (2011-2015). In this national development strategy plan, China pledges to preserve Hong Kong's status as an international financial, trading and shipping centre, and to support Hong Kong to be an offshore RMB centre and an international asset management centre. During his visit to Hong Kong in August 2011, China's Vice-Premier Li Keqiang unveiled a package of measures aimed at boosting Hong Kong's financial services industry. These measures include a possibility to repatriate RMB through foreign direct investment (FDI), the launch of a RMB qualified foreign institutional investors scheme (RQFIIs), and expansion of RMB-denominated bond issuance (sovereign and corporate) in

¹ All economic data pertaining to the Hong Kong economy are official statistics released by the Hong Kong Census & Statistics Department.

² Source: Hong Kong Financial Services and the Treasury Bureau.

³ According to the Hong Kong Stock Exchange and Clearing Ltd. (HKEx), the Hang Seng Index closed at 18434 at end-2011.

⁴ According to HKEx, total equity capital raised, including new share floatation and post-listing arrangements on the Main Board and the Growth Enterprise Market, fell by 42.6% to HK\$488.3 billion in 2011. Within this total, the amount of funds raised through IPOs dropped by 41.8% to HK\$258.9 billion.

Hong Kong. The new measures will gradually expand the channels for RMB fund flows between Hong Kong and China, and strengthen Hong Kong as the offshore centre for RMB. RMB business grew rapidly in Hong Kong over the last year. Hong Kong hosted the largest pool of RMB liquidity outside China and handled 84%⁵ of China's cross-border RMB trade settlement. Total RMB deposits in Hong Kong amounted to ¥588.5 billion at the end of 2011, an 86.9% increase from 2010; total issuance of RMB-denominated bonds exceeded ¥100 billion⁶. With the availability of financial expertise, well-established financial industry infrastructure, and more importantly a unique relationship with China, Hong Kong is expected to continue to play a key role in the internationalisation of RMB in the years to come.

Economic integration with Guangdong Province continued to deepen through the implementation of the Framework Agreement on Hong Kong/Guangdong Cooperation signed in 2010. The 12th Five-Year Plan further pledges to support Guangdong in taking a pilot and leading role in the opening up of service industries to Hong Kong, and urges for the early implementation of major cooperation projects between Guangdong, Hong Kong and Macao. Hong Kong and Guangdong have made pledges to enhance cooperation in the development of a wide range of areas such as cross-boundary infrastructure facilities, modern service industries, innovation and technology for manufacturing industries, environment and education.

In December 2011 Hong Kong and China signed the eighth supplement to the Closer Economic Partnership Arrangement ("CEPA"). Supplement VIII provides for a total of 32 services liberalisation and trade and investment facilitation measures of which 15 relate to RMB offshore activities. It also relaxes origin criteria for trade in goods, as well as the definition of "Hong Kong service suppliers", offering them greater business opportunities in China. Including the measures in Supplement VIII to CEPA, there are altogether 301 liberalisation measures under 47 service sectors. Vice-Premier Li Keqiang stated that China would fully liberalise service sectors to Hong Kong by the end of 2015.

Apart from CEPA, Hong Kong has intensified its pursuit of bilateral and regional agreements. In June 2011, Hong Kong and the European Free Trade Association (EFTA) signed a free trade agreement. It is Hong Kong's third FTA, following the agreements with China and New Zealand. FTA negotiations with Chile have also started. With the support of China, Hong Kong has conveyed to ASEAN its wish to join the China-ASEAN Free Trade Area. More generally, Hong Kong has stated that it would continue to be an active member of the WTO and APEC to pursue trade and investment liberalisation.

EUROPEAN UNION – HONG KONG RELATIONS AND COOPERATION

During 2011, the European Union and Hong Kong bilateral relations and cooperation continued to expand. Hong Kong remains an important player in the region and an intermediation platform for trade and investment flows between the EU and Mainland China.

The EU maintained its position as Hong Kong's second-largest trading partner after Mainland China in 2011. Hong Kong was the 16th largest trading partner of the EU. Bilateral trade between the EU and Hong Kong grew steadily by 8.8% to €30 billion in the first nine months of 2011.

⁵ Source: Hong Kong Monetary Authority, up to first half of 2011.

⁶ Source: Hong Kong Monetary Authority.

The EU was the biggest foreign investor in Hong Kong, next to Mainland China and the British Virgin Islands, contributing to 9.9% of the total FDI stock in 2010. Hong Kong investment in Europe has continued to develop steadily; it is one of the major sources of direct investment from Asia. Despite the global economic crisis, Hong Kong continues to be home to one of the biggest European business communities in Asia and continues to attract a large number of European citizens to reside and work in the territory, totalling around 31,930 at the end of 2011⁷. The EU is the largest source of foreign companies in Hong Kong with 454 regional headquarters, 695 regional offices and 670 local offices as of June 2011⁸, outnumbering those of the US and Japan. The EU's business presence covers a large variety of sectors, mainly financial and business services, trading, logistics, construction and retailing. EU companies are also key players in the banking, insurance and securities sectors of Hong Kong.

Hong Kong also serves as a key hub for flows of foreign direct investment from the EU into Mainland China, and vice versa. The reasons for this include Hong Kong's proximity to and established business ties with Mainland China, the simple tax system of Hong Kong, the availability of high-quality service providers in areas such as finance, accountancy and law, as well as the physical presence in Hong Kong of an increasing number of EU and Mainland Chinese companies. In addition, Hong Kong provides an ideal forum for raising capital for investment or expansion of business operations, be that through IPOs, secondary listings or bond issues (including RMB-denominated bonds).

The 5th Structured Dialogue meeting between the European Union and the Hong Kong SAR Government took place in Hong Kong on 8 December 2011. The meeting covered a range of issues from economic relations, including trade and investment, to aviation, environment, research, technology, innovation and educational cooperation, financial services, competition legislation, traditional Chinese medicines, emissions trading and climate change, and customs matters. The two sides noted that their trade and economic relations had continued to develop and deepen and bilateral trade had steadily returned to the levels enjoyed prior to the 2008-09 financial crisis. Constructive exchanges on the regulatory reform of the financial services sector and testing and certification have continued to take place at technical level. The Structured Dialogue is a well established platform that allows the EU and Hong Kong to move forward their relationship. Moreover, the EU remains committed to continue exploratory talks on possible cooperation in the area of taxation of savings.

Despite the agreement in 2010 between the European Commission and Hong Kong on how to restore legal certainty to the EU – Hong Kong bilateral air services agreements there has only been limited progress in bilateral negotiations between Hong Kong and the relevant EU Member States. With a view to ending legal uncertainty, it is highly desirable that Hong Kong completes the process of amending its air services with all relevant EU Member States, either through bilateral negotiation, or by the conclusion of a “horizontal agreement” with the EU. 2011 saw an increase in the number of high-level visits between the European Union institutions and Hong Kong SAR that culminated with the high level encounter between EU Council President Van Rompuy and Hong Kong Chief Executive Donald Tsang in September as well as meeting with Commissioner for Foreign Trade, Karel de Gucht. Exchanges at ministerial level have also expanded with the visit to Hong Kong in May of Commissioner Hedegaard (Climate Action) to deliver the keynote address to the World Consumer's

⁷ Source: Hong Kong Immigration Department

⁸ Source: Hong Kong Census and Statistics Department

Conference and the trip to Brussels in October of Hong Kong Secretary for Justice Wong Yan Lung where he had meetings with Vice-President and Commissioner Reding (Justice, Fundamental Rights and Citizenship). Regular senior official visits have helped maintain substantial exchanges in areas of common interest including financial services regulations and anti-corruption activities. Delegations of Members of the European Parliament have also passed by Hong Kong and contributed to enhancing our cooperation.

The activities of the EU Business Information Programme for Hong Kong and Macao (EUBIP), co-funded by the European Commission and under the management of the European Chamber of Commerce (ECC) in Hong Kong, have continued to increase in number and have become more diverse. During 2011, priority was given to the sovereign debt crisis in Europe, financial services regulations, CEPA, environment and climate change, and trade relations between the EU and Greater China. The EUBIP business councils established for sectors in which European business and industry enjoy a leading position, e.g. information and communications technology (ICT) and financial services, have continued to provide important industry input to our government-to-government dialogue. EUBIP continues to be a successful channel for an increased understanding between the business communities of the EU and Hong Kong.

To further intensify ties with Hong Kong, the EU and the EU Member States officially represented in the territory have increased public diplomacy efforts, to make the EU more visible in Hong Kong and increase the knowledge and information on EU policies including trade and regulatory policies, energy and climate change, financial services regulation, customs matters, gender equality policies, intercultural dialogue, and the EU's role in the world. They have also worked closely together to enhance people to people contacts and promote academic exchanges with joint activities such as the EU Education Fair and the EU Film festival. In late 2011, the EU launched a call for proposals for an EU Academic Programme in Hong Kong which will run from 2012-2015. The main objective is to develop outreach activities to enhance the visibility of the EU and strengthening academic cooperation with EU higher education institutions, including encouraging more scholars and students to undertake research and studies on EU related issues.

The EU will continue to nurture its relationship with Hong Kong SAR, increase economic and trade links, enhance cooperation with business and civil society and promote mobility and exchanges with the Hong Kong people.